

The Department has declined to issue a ruling in this letter regarding the use of encrypted keys in computer licensing agreements. See 86 Ill. Adm. Code 130.1935. (This is a GIL.)

June 24, 2004

Dear Xxxxx:

This letter is in response to your letter dated October 1, 2003, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.ILTAX.com to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

We are writing to you on behalf of a client (the Company) which is requesting a General Information Letter (GIL), pursuant to 2 Ill. Admin. Code Sec. 1200.120. The GIL would address the sales taxability of software which the Company conveys to other businesses. GILs respond to inquiries made by taxpayers or their representatives. We understand that GILs discuss tax principles or applications and are not binding on the Illinois Department of Revenue (the IDOR).

FACTS

The Company operates at an Illinois location. It provides technology-infrastructure consultation and management to its clients. It is also a value-added re-seller of licensed software. The Company makes software sales through the internet. It works almost exclusively in this regard with only one software licensor (the Licensor).

The software licensing procedure is as follows:

1. A Company salesperson contacts a perspective client, generally another business, (the Licensee).

2. If the Licensee expresses an interest in buying software, the salesperson creates a sales order having the following information – Licensee's name, bill-to, mailing, and email addresses, and software type, quantity, description, and cost.
3. At the same time as step #2 (above), the Licensee sends to the Company its own purchase order which should contain the same information as the Company's sales order.
4. The Company then matches the information on its sales order with the information on the Licensee's purchase order.
5. If the information on the respective orders matches, the Company sends its own purchase order, along with the Licensee's, to the Licensor.
6. The Licensor reviews the Licensee's order and then emails to both the Licensee and the Company a confirmation receipt. The email contains the aforementioned purchase-order information and a special identification number unique to the sales transaction in process.
7. To consummate the sales transaction, the Licensee has to access the Licensor's website and set up an account there. The Licensee uses its special identification number and a temporary password (i.e., the first three letters of its business name) to access the website.
8. Once on the website, the Licensee next needs to create for itself a unique username (in alpha or alphanumeric code) and a permanent password.
9. The Licensee enters onto the website the username and password just created to gain access to the Licensor's support webpage.
10. The support webpage next prompts the Licensee to read a written end-use license agreement (the Agreement). Once the Licensee reviews the Agreement, but before it can continue the transaction in process, it must select the 'I Agree' symbol at the end of the Agreement. The Licensee's acceptance of the Agreement allows it to continue, but still not complete, the software-retrieval process.
11. After the Licensee accepts the Agreement, the Licensor routes it to the license-request webpage screen. The screen prompts the Licensee to enter its identification number, email address, purchase-order number, and other information identifying where the software will be run, the quantity of licenses requested, and the type of operating system the Licensee uses.
12. After the Licensee enters the aforementioned information, the Licensor sends it an email confirmation which includes the Agreement and a 'key' authorizing it to use the software. A key is an encrypted, randomly-generated string of alphanumeric characters. The Licensee needs the key to retrieve for use the software which it wants to buy. Once the Licensee applies the key, it may utilize the software ordered, and the software sale is then complete.

The Agreement has the following attributes:

- Both the Licensee and Licensor sign the written Agreement electronically. The Licensee cannot in this respect access the software (or even the webpage screen) without first providing the Licensor with a self-generated username. The username possesses the same salient characteristics as an ink-on-paper signature:
 - It is a mark of lasting impression, dated and embedded in the Licensor's webpage.
 - The username as an identifier is demonstrably unique and is acknowledged by the Licensor as associated with a special person.

- The username expresses the Licensee's intent to authenticate the Agreement, with which it is associated. The Licensee pledges in providing the username, in conjunction with selecting the 'I agree' symbol, to abide by the terms and conditions of the Agreement.
 - The Licensee cannot access the software – cannot install, open, or use it in any way – unless it first creates and then enters onto the screen its unique username.
 - The username has legal effect. It stands for the Licensee's assumption of certain rights and responsibilities -- namely, empowerment to require the Licensor to uphold the Agreement's terms and conditions and accountability to require the Licensee itself to uphold them. According to the Licensor's legal counsel, the username, as an electronic signature on the Agreement, is binding on all the parties involved and has the same legal effect as an agreement signed with ink on paper.
- The Licensor does not in effect accept the Licensee's offer to purchase the software until it sends the Licensee an encrypted key for unlocking it. When the key is expressed online, the Licensor becomes bound to the Licensee's offer to purchase the software. Like the Licensee's username, the key has the same salient characteristics as an ink-on-paper signature.
 - The key is unique to the Licensor and to the transaction and is acknowledged as such by all parties.
 - It expresses the Licensor's intent to pledge itself to the agreement and be bound legally by its terms.
 - But for its issuance, no sales transaction would take place.
 - The Agreement restricts the Licensee's duplication and use of the software: 'Licensee may only make copies of the Software and Documentation in a reasonable number and only for backup or archival use...'. (Article 2.2).
 - The Agreement prohibits the Licensee from licensing, sublicensing, or transferring the software to a third party: 'Licensee may not sublicense, translate, resell, lease, lend, rent, [or] distribute' the software to any third party (Article 2.1).
 - The Agreement allows the Licensee to keep a backup or archival copy of the software which is only allowed to be used in an emergency (Article 2.1. and 2.3(f)).
 - The Licensee must destroy upon the Agreement's termination all copies of the software. 'Licensee shall cease using all software...and destroy the Software and all related documentation.' (Article 5). Further, the Agreement is described as a 'perpetual license.' (Article 2).

(A copy of the Agreement is attached.)

ISSUE

Is the Agreement exempt from the Retailers' Occupation Tax (the ROT)?

LAW

Illinois imposes the ROT upon persons engaged in selling within the state tangible personal property at retail. 35 ILCS 120/2. Illinois specifically imposes the ROT on the sale at retail of canned software, including the transfer of software subject to manufacturer licenses restricting its use or reproduction. Further, canned software remains tangible personal property subject to the ROT even when transmitted electronically to the buyer. 86 Ill. Admin. Code Sec. 130.1935(a). However, a software license agreement is not subject to the ROT if:

- A. It is evidenced by a written agreement signed by the licensor and the customer.
- B. It restricts the customer's duplication and use of the software.
- C. It prohibits the customer from licensing, sublicensing, or transferring the software to a third party (except a related party) without the permission and continued control of the licensor.
- D. The licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy.
- E. The license is perpetual, or the customer must destroy or return all copies of the software to the licensor at the end of the license period.

86 Ill. Admin. Code Sec. 130.1935 (a)(1)(A)-(E). Therefore, software license agreements that meet all five aforementioned criteria would not be subject to the ROT.

The IDOR regulation requires that both the licensor and licensee sign the software licensing agreement. 86 Ill. Admin. Code Sec. 130.1935(a)(1)(A). The regulation does not explicitly state however the form in which the signing should be made. In other words, it does not ostensibly prohibit a signing executed in electronic format as distinguished from one made with ink on paper.

Pursuant to Illinois law (the *Electronic Commerce Security Act* at 5 ILCS 175/), a signature should not be denied legal effect, validity, or enforceability solely on the ground that it is in electronic form. Illinois law also provides guidelines for what constitutes a genuine electronic signature. An electronic signature means a signature in electronic form attached to, or logically associated with, an electronic record. 5 ILCS 175/5-105. The purpose of the electronic signature is to authenticate the record. 5 ILCS 175/5-105. An electronic signature may be validated in any manner - including by showing that a procedure exists by which a person executes a symbol (i.e., and alpha-numeric code) or a security procedure (i.e., an answer-back/acknowledgement routine) for the purpose of verifying that an electronic record belongs to it. 5 ILCS 175/5-120(b). The law also describes the qualities which an electronic signature should have to afford it the same legal effect as a ink-on-paper signature – namely, integrity, security, and confidentiality. 5 ILCS 175/25-101(b)(3). Central to the qualities appears to be encryption: The signature should be encoded by its maker so that only the maker and the party to whom it is directed be able to decode it. 5 ILCS 175/5-105. If these requirements are met, an electronic signing would satisfy the rule of law requiring a signature. 5 ILCS 175/5-120(a).

Several IDOR regulations address the use of electronic signatures - 86 Ill. Admin. Code Secs. 107.110, 530.320, and 760.230. The regulations require that, in order to have the same legal effect as an ink-on-paper signing, the electronic signature needs to be made

secure and confidential through encryption. It also needs to have integrity as the lasting, recorded impression of a unique maker and be verifiable by other responsible parties as belonging to the maker. One IDOR regulation states that a taxpayer's social-security number and personal-identification number would meet these requirements. *86 Ill. Admin. Code Sec. 107.110*. Another IDOR regulation states that a personal identification code which a taxpayer selects and registers with the IDOR would serve as an electronic signature. *86 Ill. Admin. Code Sec. 760.230*. A third regulation states that an electronic-signature code consists of encrypted data which use a combination of the taxpayer's name, social-security number, and date of birth. *86 Ill. Admin. Code Sec. 530.320*.

Analysis

The Agreement is exempt from the ROT because it meets the five tests for nontaxability, pursuant to *86 Ill. Admin. Code Sec. 130.1935*. This may be demonstrated as follows:

- The Agreement is written and is signed in electronic format by the Licensee and Licensors. The Licensee's input of a unique username and the Licensors' issuance of an encrypted key meet the requirements for a valid electronic signature as stipulated in Illinois law and in several IDOR regulations:
 - The Licensee's unique username (in alpha or alphanumeric code) has integrity, as a distinguishing self-made mark of lasting impression, both dated and embedded in the Licensors' webpage.
 - It has confidentiality in that only the Licensee in its making and the Licensors in its receipt acknowledge that it is associated with a special person and particular transaction.
 - The username offers security to the Licensors in that the Licensee can neither access the software – nor install, open, or use it – until it enters its unique username on the webpage.
 - By entering its unique username, in conjunction with selecting the 'I agree' symbol, the Licensee authenticates the Agreement by pledging itself to the Agreement's terms and conditions. In this regard, employing the username has legal effect, as the Licensors' counsel considers it as binding the Licensee to the Agreement.
 - The Licensors' encrypted key has the same qualities - integrity and confidentiality - as a self-made mark unique to its maker and the transaction and identifiable by all responsible parties as such when sent to the Licensee.
 - The key also offers security as it is encoded and can only be decoded – providing for release to use the software – when the Licensors accept the Licensee's offer to buy the software. By issuing the encrypted key, the Licensors therefore authenticate the Agreement and become legally bound to it.
- The Agreement restricts under Article 2.2 the Licensee's duplication and use of the software.
- It prohibits under Article 2.1 the Licensee from licensing, sublicensing, or transferring the software to a third party.

- It allows under Articles 2.1 and 2.3(f) the Licensee to keep a backup or archival copy of the software.
- It requires under Article 5 that the Licensee destroy the software should the Agreement terminate. Article 2 also states that the Agreement is perpetual.

Contrary Authority and Discussion

In one GIL, a customer evidenced its acceptance of a licensing agreement by clicking 'accept' while buying software online. The GIL ruled that the IDOR does not consider this acceptance to constitute a written and signed agreement, pursuant to 86 Ill. Admin. Code Sec. 130.1935. ST 02-189-GIL (9/14/02). However, the current facts differ from these because the Licensor and Licensee's Agreement involves use of an encrypted key and a unique username which should satisfy under Illinois law the requirements for an electronic signature and IDOR regulatory requirements relative to signed and written software license agreements.

Illinois law also states, however, that a state agency is not required to use or permit the use of electronic signatures. 5 ILCS 175/25-101(e). Further, the IDOR has stated that, while it has been granted the authority to accept electronic signatures, it may do so provided that it first promulgates a regulation allowing for their acceptance. ST 00-0053-GIL (3/16/00).¹

In response to this position, the following points should be made:

- The provision of Illinois law cited in ST 00-0053-OIL (and reproduced in footnote #1 below) enables, but does not require, the IDOR to adopt rules setting forth standards for accepting electronic signatures.
- The regulation (86 Il. Admin. Code Sec. 130.1935), while requiring a signing, does not explicitly state the form in which the signing should be made.
- The regulation does not on its face prohibit a signing executed in electronic format.
- The intent of the regulation, it would appear, is that both licensee and licensor pledge to be bound legally, by making their respective signings in any acceptable form, to the terms and conditions of the Agreement.
- Illinois law has recognized that electronic signatures may have legal effect and has provided guidelines on what constitutes their validity.
- The IDOR has issued several regulations which allow for the use of electronic signatures provided that the aforementioned guidelines be followed.
- It is believed that the IDOR may apply the guidelines already established to ascertain pursuant to the current case whether properly-executed electronic signatures meet the signing requirement stipulated in 86 Ill. Admin. Code Sec. 130.1935 (a)(i)(A).

CONCLUSION

The facts of the case support the finding that the Agreement satisfies the criteria for nontaxability provided in 86 Ill. Admin. Code Sec. 130.1935(a)(1) and, therefore, should not be subject to the ROT. This conclusion is consistent with state law and IDOR regulations.

We respectfully request that the IDOR send to us on behalf of the Company a GIL addressing the issue presented. Your cooperation is appreciated.

DEPARTMENT'S RESPONSE:

We have reviewed the information provided in your letter and attachment. We are unable to issue you the type of ruling you have requested. The Department will take this issue under advisement and appreciates you providing your analysis of this issue.

I hope this information is helpful. If you require additional information, please visit our website at www.ILTAX.com or contact the Department's Taxpayer Information Division at (217) 782-3336. If you are not under audit and you wish to obtain a binding PLR regarding your factual situation, please submit a request conforming to the requirements of 2 Ill. Adm. Code 1200.110 (b).

Very truly yours,

Terry D. Charlton
Associate Counsel

TDC:msk

¹ To support the statement, the GIL cites the following provision of Illinois law: 'The Department *may* [our emphasis] adopt rules to authorize the electronic filing of any return or document required to be filed under any Act administered by the Department. In the case of an electronically filed return or other document required to be filed with the Department or maintained by any taxpayer, these rules may set forth standards that provide for acceptance of a signature in a form other than in the proper handwriting of the person' (as recodified from 20 ILCS 2505/39c -1a to 20 ILCS 2505/2505-200).